

December 4, 2002

THE 50% PRINCIPLE — Let's take a look at the very big picture as seen via the 50% Principle. For the benefit of new subscribers, I want to review the 50% Principle.

I gleaned the 50% Principle from the great Dow Theorist, George Schaefer. Schaefer stated that he dug up the 50% Principle from his study of Dow's writing.

Nov. 15, DJIA 8578.26; PTI 5249; A-D Ratio -4.62
Nov. 22, DJIA 8804.84; PTI 5250; A-D Ratio -4.05
Nov. 29, DJIA 8996.09; PTI 5257; A-D Ratio -3.80
S&P Yield: 1.69 S&P p/e: 35.02
Gold 50-Day MA: 319

At any rate, what a major average does (I use the Dow) at the 50% or halfway level of a major advance or decline is critically important. Example — on a decline it's important to note whether the Dow halts above the halfway level of the

preceding advance. If, on a decline, the Dow can retain 50% of the ground gained on the preceding advance-- that's a bullish situation, and often leads to a test of the highs again.

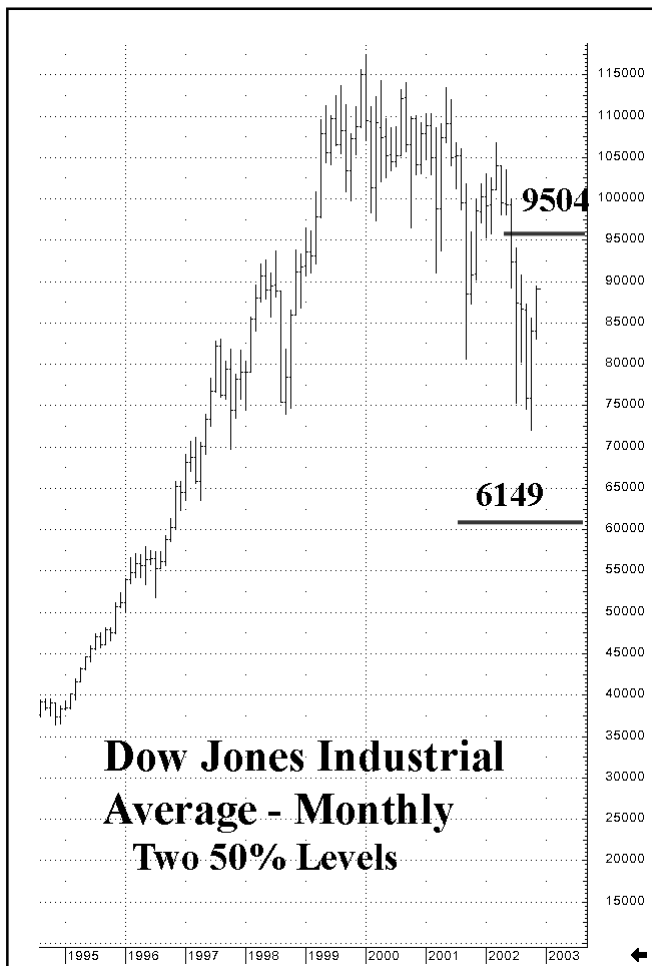
On the other hand, if the decline wipes out more than half of the preceding advance, that's a bearish situation and the Dow will usually go a good deal lower.

Referring to the current situation, this bull market began with the Dow at 577 in 1974. The bull market continued to a high of 11722 in the year 2000. That amounted to a rise of 11145. Half of that is 5572. Adding 5572 to 577 gives us a halfway level of 6149.

So 6149 becomes the 50% or halfway level of the entire bull market advance from 1974 to 2000.

The 50% Principle is saying that on a big picture basis, as long as the Dow can hold above **6149**, the picture is constructive. However, if the Dow breaks below 6149 the picture turns ominously bearish. In that case, I couldn't discount the possibility of the Dow ultimately testing the 1974 low of 577.

To put it another way, a violation of 6149 paves the way for a disastrous wind-up for this bear market.



Now let's take the bear market decline from 11722 in the year 2000 to the recent October bear market low of 7286. This was a decline of 4436 points. Half of that is 2218. Adding 2218 to 7286, we get **9504**.

Applying the 50% Principle we can now say that if the Dow can rally above 9504, this would be a very bullish technical achievement. In fact, if the Dow can advance above 9504, the way is open for a re-test of the 11722 high.

However, if on an advance, the Dow fails to better 9504, then the odds are that the Dow will, in due time, decline to test its October low of 7286. If 7286 is violated, then the odds increase that the Dow will decline further to test the 6149 level.

So summing up, the big question now is whether on any and all rallies the Dow can better **9504**. If the Dow fails to better 9504, then we will watch to see whether the Dow can hold above its October low of **7286**.

Somewhere ahead, and I obviously can't predict the timing, the Dow will either break out above 9504 or the Dow will turn down and violate 7286. So **9504** or **7286** – what the Dow does in relation to those two levels will tell us a lot about the future course of the stock market and the US economy.

Question – What if the Dow just fluctuates between 9504 and 7286?

Answer – In that case, as long as the Dow is locked in the 9504 to 7286 trading range, I believe the stock market and the US economy will do what my friend, John Mauldin, calls “muddling through.” There'll be a lot of confusing trends. The Fed will continue to tell us that “things are difficult but getting better.” The government statistics will be indecisive, but economists will apply a bullish interpretation to them. And well, we'll just “muddle along.”

But obviously, the Dow won't stay forever between 9504 and 7286. Somewhere ahead, the Dow will break out, and the 50% Principle will render its verdict. In this business, nothing lasts forever and this includes trading ranges.

ANALYZE THIS – Go to your local stationery store and buy a pack of their best bond paper. Now cut a batch of 3 inch by 5 inch rectangles. Mark each one with your name, such as “Russell \$100 dollars.” Now take a pack of these to your largest local bank and ask for the president of the bank. OK, you've got him. Here's how the conversation goes:

Russell: Sir, here are 36 one hundred dollar bills. I'd like to buy a one-ounce gold coin.

Bank: Well, we have handled gold coins, but what are these?

Russell: Well sir, these are hundred dollar notes. See, it says right on each note, Russell One hundred dollars.

Bank: But these are just pieces of paper. You can't just write “Russell One hundred dollars” on a piece of paper and call it money. Look, I'm very busy, you'll have to excuse me.

Russell: Wait, what's wrong with my paper?

Bank: You're not the government. We only deal with real money, government money.

Russell: But the stuff you deal with isn't put out by the government, it's manufactured by a private bank called the Federal Reserve.

Bank: Yes, but the government says it's "legal tender," and that it can be used in settlement of all debts. The government says it's legal.

Russell: Well, I'll be damned. The government can do that?

Bank: Yes, the government can do almost anything, as long as Congress goes along with it.

Russell: Gosh, if that's the case I'm going to take some of the government's legal tender paper and buy real money.

Bank: What are you talking about, sir?

Russell: I'm going to take the paper the government manufactures and buy gold and gold shares.

Bank: I guess that's legal. Mmmm, buying gold with paper. I'm going to talk to my wife about that.

I actually tried the above (for fun, of course), and that's roughly the way the conversation went. But now let's get serious. There are two definitions of deflation. One is asset deflation, meaning that the prices of goods and merchandise are declining in terms of the currency. A basket of goods such as cars, food, bed sheets, men's suits, bread – all on average cost less. That's asset deflation.

Then there's monetary deflation. The money supply contracts. There isn't enough money to keep the economy going. It's harder to get hold of dollars. As a result, corporations can't get financing and the economy slumps.

Right now there is no monetary deflation – just the opposite, there's monetary inflation. The Fed is seeing to that. There's plenty of bank credit. The only problem is that the banks are becoming conservative, and it's harder to get a loan, unless, of course, you've got a great credit reputation. If you have a great credit reputation, you can get all the money you want.

But there's another problem. You own a manufacturing business. You manufacture dishware. The problem is that your competition is vicious. You've been manufacturing plates and cups for decades and business has been good. But suddenly your competition is manufacturing their plates and cups out of China. What costs you three dollars for a plate costs your competition 40 cents for a plate. Now, you're either going to go to China to manufacture your plates or you're going out of business. Pricing power, you don't have any. In fact you're going to reduce the price of your plates, and as a consequence your profits are going to slide.

That's asset deflation. The price of plates and cups and saucers and everything else remotely connected with your business is being forced down.

The government isn't completely stupid. They see what's going on. And they've come up with the solution. We'll pressure China to raise the price of their currency. That will render Chinese exports more expensive and help our manufacturers — or at least those who still manufacture in the US. But will the Chinese go along with this great idea? Will they make the Chinese renminbi convertible and raise its conversion value vs. the dollar?

Well, why would China do that if they're competing with the US and the rest of the world? And on top of that, they have a terrible unemployment problem, and they want to build as many factories as possible, and they want to put as many people to work as possible.

Well, we could threaten China with restrictions on their imports to the US. That might move them to raise the value of the

renminbi.

Yeah, and the Chinese might try to swing a deal where the US would move out of Asia. And – well, it's a very sticky problem, and I haven't really come up with the answer yet.

But the current reality is clear enough. China has become manufacturer to the world. And India is fast becoming service supplier to the world.

This is resulting in a massive current account deficit for the US. So what's holding the dollar up? Well, the US is still the most powerful nation in the world. Powerful in what way? Powerful militarily. The US has built the mightiest military force the world has ever seen. And Mr. Bush is letting the world know it. We spend more on our military than most of the rest of the world taken together. So your money and your investments are safe here.

Foreign friend – “Gee, that's a fact, I guess. But let me think about that a while. You see, we still have the problem that the US isn't competitive. And it's getting worse year by year. And what's that – you want us to join you in the coming war with Iraq? Listen, you've got this huge military, why don't you do the war thing, and we'll just hold back, but we'll back you in that we won't object. We'll even back you in our official dispatches.”

NOTES & QUOTES – I guess you read the rumors that Warren Buffett was going to bid to buy Burger King. Pure baloney, it was just a plant to try to get a better price for Burger King.

What Buffett really is interested in is the insurance business. Everything else is a sideline, “small potatoes.” The insurance business is a great business. The insurance company takes your money, and you try to get back a portion of what you put in. Buffett believes stocks are high here and mostly unattractive.

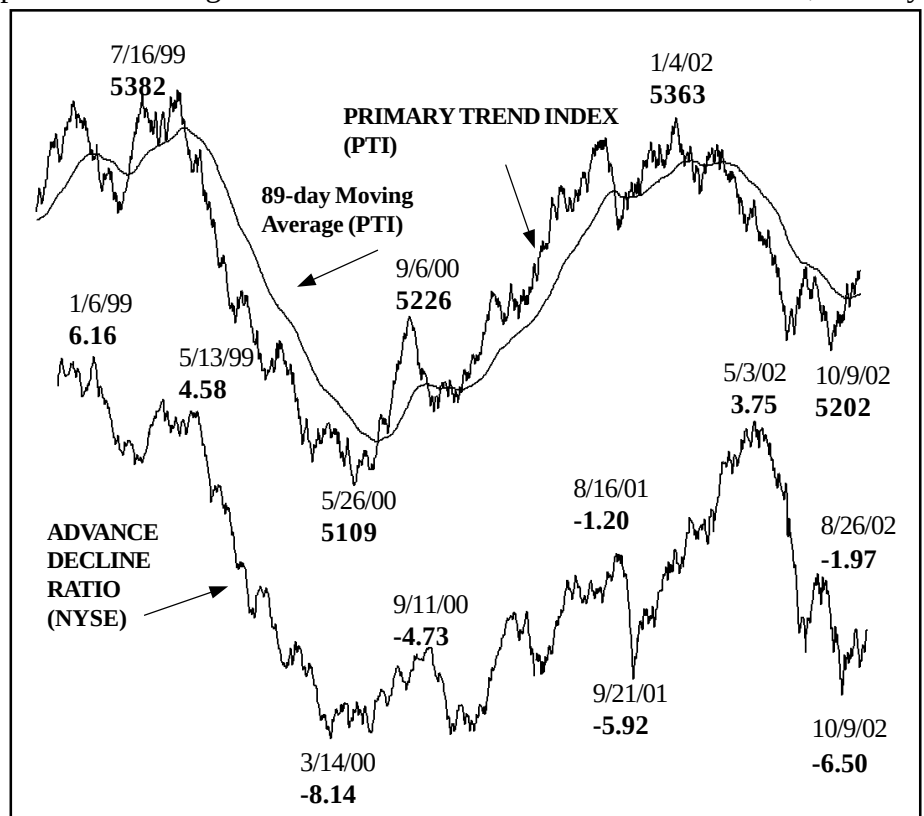
Actually, the insurance business can be compared with the Vegas casinos. The casinos have the odds on their side, and they KNOW that if you play long enough they're going to take your money. So everything at the casinos is geared to keep you playing. The big fear of any casino is an occasional gambler who makes a Big Hit – and then leaves.

So what Buffett does is buy whole corporations as long as they are throwing off cash. But basically, he's a “numbers man,” and the favorable numbers are in the insurance companies.

With the fear of loss due to terrorists, the insurance companies have even got the US government to back any potential large losses that might be suffered by them due to terrorist attacks.

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Is tech reviving? According to the Associated Press, “This rally isn't driven as





INVESTMENT POSITION – The bear remains in the box. But question — what do you do with your money in a long-lasting bear market?

This is one of the toughest questions I have to deal with. One professional who has a website starts every site with the words, “Cash is King.” And he may well be right. If T-bills are comparable with cash, then T-bills have beat the Dow ever since this bear market started in September 1999.

I did better than T-bills. I put most of my money in muni bonds paying 5.25% and a bit more in tax-free funds. Actually, bonds have outperformed stocks over the last three years. They haven’t done that since 1929, 1930, 1931, that’s assuming that you owned Treasuries.

OK, but what do we do now? My best answer to this is that we compound with the safest vehicles that we can find. I guess the single safest vehicle (aside from gold, which is pure money) is the 10-year TIPS. The yield on the TIPS is 2.54% and the TIPS are protected against inflation.

You could just put all your money in TIPS and wait for the bear market to end. But that’s too simple and too boring for most subscribers. So they fool around, buy this or that, and probably lose their money. But that’s OK, as long as you keep the losses at a minimum.

You can buy muni bonds and hope the bond market will hold up. You can buy utility stocks or better industrial bonds or high-yielding preferred stocks. Or you can try to “beat the bear” as I’ve attempted to do when I suggested that you buy Diamonds.

You can do any or all of these things. You can even buy gold coins or gold shares, and patiently wait for the gold bull market to kick into its second phase.

Remember this – in a primary bear market your main object is NOT TO LOSE MONEY – making a profit is secondary.

much by tech-company earnings as it is by big institutional investors looking to boost year-end returns. ‘It’s the season for professional money managers to try to pad their performances by the end of the year. That’s what’s behind this,’ said Brian Belski, fundamental market strategist at US Bancorp Piper Jaffray in Minneapolis.”

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Great men can be strange men. Einstein was one. The great one tired of his first wife. By 1914 Einstein presented his wife (who was a physicist named Mileva Maric) with a list of “conditions” under which he would consent to remain married to her. He demanded that his wife have three meals a day delivered to his room. He also threatened, “You are neither to expect intimacy nor to reproach me in any way.”

His second marriage proved to be as strange as his first. He was permitted to meet Betty Neumann, a niece of a friend. Einstein “met” Miss Neumann twice a week for a decade.

Einstein’s divorce from his first wife was typically strange and a testament to his giant ego. He assumed that he would win a Nobel Prize, and he told his lawyers to make part of his potential Nobel Prize money part of the divorce settlement.

But the world as we know it owes a huge almost incalculable debt to Einstein. Under advice from his friends Fermi and Szilard, Einstein wrote a letter to President Roosevelt stating that the Germans were on the path of developing an atomic bomb, and he urged the President to beat the Germans to the bomb. So great was Einstein's authority that Roosevelt took the letter to heart. This led to the Manhattan Project, which produced the atomic bomb.

Had the Germans developed the atomic bomb before the Americans, we'd most probably be living in a Nazi world today. The prime irony of the situation was that many of the Jews who were responsible for the development of the bomb were driven out of Germany by the Nazis. Had the Nazis not had their anti-Semitic program, the German Jews might have been forced to create the atomic bomb – in which case you and I would be speaking German today.

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The California town of Desert Hot Springs filed for bankruptcy, the first such bankruptcy in seven years. But last week we got a surprise; its Mayor, Matt Weyuker, filed for personal bankruptcy. In a letter, Weyuker said that a weakened stock market and a recent lawsuit sapped him and his wife of their savings.

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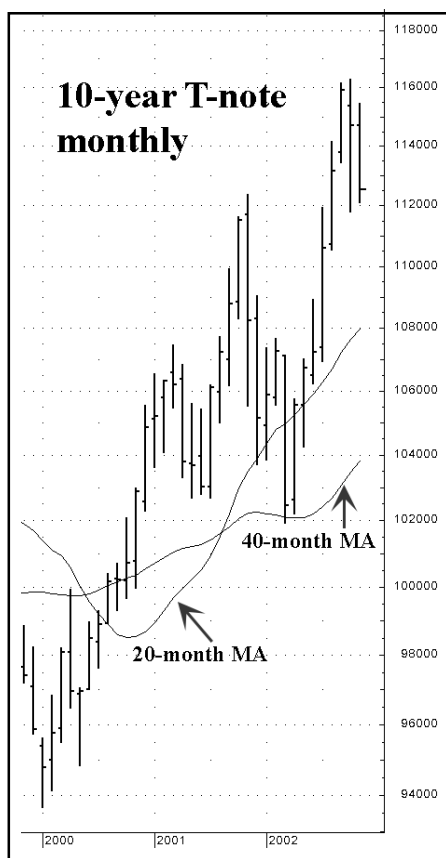
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John Chambers, CEO of Cisco, from a recent interview: "Are you worried about Chinese competition?" Chambers answered, "China is generating as many engineers as the US. They only do 2% of the business the US does. Not only jobs but companies will go where the best-educated work force is – so the competition from Asia will be huge."

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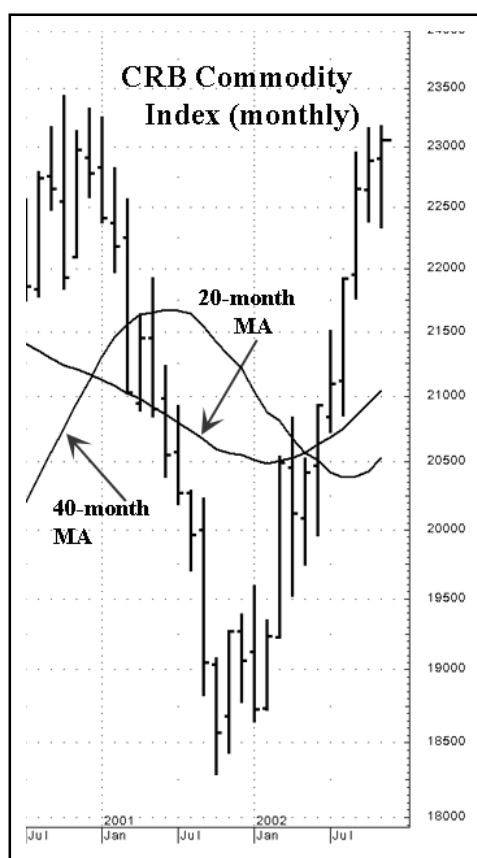
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LONG-TERM – The juxtaposition of the 20-month moving average and the 40-month moving average can tell us a lot about long-term trends.



This first chart shows the 10-year Treasury Note. Note that the 20-month MA crossed ABOVE the 40-month MA in August of 2001. As of now, the faster-moving or 20-month MA stands at 107.51. The 20-month MA stands today at 107.31 while the actual 10 year T-note stands at 112.14. Conclusion – the 10 year T-note continues to remain on the bullish side of its long-term MA.

The return of inflation – Here's a chart of the Reuters CRB Index. Here we see that the 20-month MA turned up in February 2000, while the 40-month MA turned up in February of 2002. The 20-month dropped below the 40-month in May 2002, but now the 20-month has turned up again. Both MAs are now rising, although the 20-month is still below the 40-month. My interpretation is that the trend is in the process of turning up for the Commodity Index. This bespeaks of



commodity inflation and before long inflation across the board. Of course, this is long-term bullish for gold.

Next Mailing: December 24, 2002